



# **FIRST QUARTER 2003**

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William A. Garrahan  
Chief Executive Officer



Juan A. Santiago  
Chairman of the Board

April 29, 2003

# Management's Discussion and Analysis of Financial Condition and Results of Operations

*(dollars in thousands)*

The following commentary reviews the consolidated financial condition and results of operations of Puerto Rico Farm Credit, ACA (Association) for the three months ended March 31, 2003. These comments should be read in conjunction with the accompanying consolidated financial statements, notes to the consolidated financial statements and the 2002 annual report of the Association.

## **LOAN PORTFOLIO**

The Association provides funds to farmers, rural homeowners and farm-related businesses for financing short and intermediate-term loans and long-term real estate mortgage loans. The Association also maintains a portfolio of purchased loans, originated by other Farm Credit System entities and non-system entities. The Association's predominant local service area (LSA) agricultural commodities were dairy, livestock and fruits which totaled approximately \$110 million or 52 percent of all outstanding loan volume at March 31, 2003.

The gross loan volume of the Association at March 31, 2003 was \$207,706, an increase of \$3,196 or 1.6 percent as compared to \$204,510 at December 31, 2002. Net loans outstanding at March 31, 2003 also increased by the same amount, as there was no change in the allowance for loan losses. The improvement in gross loan volume was primarily related to a \$3,010 increase in net participation loans purchased. Otherwise, increases in LSA loan volume were mostly offset by scheduled annual payments.

Net loans at March 31, 2003 made up 96.9 percent of total assets, the same percentage as at December 31, 2002. However, this compared to 95.9 percent at March 31, 2002. The increase during the past year was the result of the material decline in other assets. In December 2002, other assets decreased by \$788 due to the underfunded status of the retirement plan, and the elimination of the related prepaid asset.

As a percentage of gross loans, nonaccrual loans equaled 1.9 percent at March 31, 2003, compared to 2.2 percent and 2.4 percent at December 31 and March 31, 2002, respectively. The decrease in the percentage was primarily the result of a partial payment received from the sale of collateral property related to a large volume account. There is a plan in place to liquidate the remaining collateral. Due to the substantial increase in loan volume, the overall credit quality of the total portfolio continued to show improvement. Credit quality has also been supported and enhanced by the lower interest rate environment, favorable weather and stable product demand.

The Association maintained an allowance for loan losses in an amount considered by management as sufficient to absorb the estimated risk inherent in the loan portfolio. The allowance for loan losses was the same at March 31, 2003, as at December 31, 2002. The first quarter 2003 analysis identified less risk as a result of a lower level of nonaccrual loans and improved credit quality. The ratio of allowance to gross loan volume was 3.1 percent at March 31, 2003 and 3.2 percent at December 31, 2002. There were no chargeoffs or recoveries during the first quarter of 2003.

## **RESULTS OF OPERATIONS**

Net income for the three months ended March 31, 2003 totaled \$440, a decrease of \$372 or 45.8 percent as compared to the first quarter of 2002. Despite a higher level of accruing loan volume and a reduction in nonaccruing loan volume, net interest income decreased. At March 31, 2003, net interest income was \$1,393 a decrease of \$137 or 9.0 percent compared to the first quarter of 2002. During the first quarter of 2003, interest income recognized from the collection of nonaccrual loans totaled \$74, a reduction of \$102 from the first quarter of 2002. Management continues to project lower levels of interest income from nonaccrual loans.

During the first quarter of 2002, a decision by management to reduce the allowance for loan losses resulted in a \$174 enhancement of income. During the first quarter of 2003, the allowance was not changed, resulting in no impact to income.

Noninterest income for the three months ended March 31, 2003 was \$89, an increase of \$23 as compared to the first quarter of 2002. Primarily, this was the result of increased fee income from the recognition of prepayment penalties related to participation loans.

Noninterest expense for the three months ended March 31, 2003 increased by \$104 or 11.1 percent compared to the same period of 2002. The increase was related to increases in noncontrollable expenses. First, salaries and employee benefits increased by \$58 or 9.1 percent. Actual salary related expenses decreased; however, benefits expenses related to pension and post-retirement medical insurance increased. Second, as projected in the 2002 Annual Report, expenses related to the Farm Credit System Insurance Fund premium and the AgFirst Farm Credit Bank (the Bank) guarantee fee increased. During the first quarter of 2003, these two expenses totaled \$117, an increase of \$57 or 95 percent, compared to first quarter 2002 when both expenses totaled only \$60.

During the first quarter of 2003, the Association recognized federal income tax expense of \$1 related to the filing of 2002's federal tax return. This compared to first quarter 2002, when federal tax expense totaled \$21, \$6 related to the filing of 2001's federal tax return and \$15 related to the quarterly provision for income tax expense. Management anticipates that 2003's federal tax liability will continue to benefit from 2001's restructuring into a holding company. As a result of the restructuring, a majority of the Association's business has been conducted in the tax-exempt subsidiary or as possession-sourced activity eligible for tax credits. Thus, no provision for income tax expense was recorded during the first quarter.

**Key Results of Operations Ratios:**

	<b>Annualized for the three months ended 3/31/03</b>	<b>For the year ended 12/31/02</b>
Return on Average Assets	.86%	2.15%
Return on Average Stockholders' Equity	3.89%	8.57%
Net Interest Income as a Percentage of Average Earning Assets	2.78%	3.34%

**LIQUIDITY AND FUNDING SOURCES**

*Liquidity*

Liquidity management is the process whereby funds are made available to meet all financial commitments including the extension of credit, payment of operating expenses and payment of debt obligations. The Association receives access to funds through its borrowing relationship with the Bank and from income generated by operations. Sufficient liquid funds have been available to meet all financial obligations.

*Funding Sources*

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The funds are advanced by the Bank to the Association in the form of notes payable. The notes payable are segmented into variable rate and fixed rate sections. The variable rate notes are utilized by the Association to fund variable rate loan advances and operating fund requirements. The total notes payable to the Bank at March 31, 2003 was \$159,030 as compared with \$154,689 at December 31, 2002. The increase of \$4,341 or 2.8 percent corresponded to the increase in gross loan volume of \$3,196 and the funding of the year-end 2002 dividend.

The Association had no lines of credit outstanding with third parties as of March 31, 2003.

*Funds Management*

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers variable rate loan products which are competitively priced according to financial market rates. Variable rate loans may be indexed to either the Prime rate or the 90-day London Interbank Offered Rate (LIBOR). The majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds management techniques to identify, quantify and control interest rate risk associated with the loan portfolio.

**CAPITAL RESOURCES**

Total stockholders' equity at March 31, 2003 increased .9 percent to \$45,278 from December 31, 2002 when total stockholders' equity was \$44,877. The increase was attributable to net income retained as unallocated surplus during the quarter.

Total capital stock and participation certificates were \$1,013 on March 31, 2003 compared to \$1,001 on December 31, 2002. The increase of \$12 was the net result of new customers purchasing more stock than was refunded to borrowers who paid their loans in full.

Retained earnings unallocated increased \$389 or .8 percent from December 31, 2002 when unallocated retained earnings totaled \$45,914. The increase was net income in excess of equity dividends declared. The Association's directors declared cash dividends for the forty-first consecutive quarter. The table below sets forth the amount of dividends declared:

<u>Quarter</u>	<u>Equity Based</u>	<u>Patronage Based</u>
First 2003	\$51	
Fourth 2002		\$1,602
Third 2002	\$50	
Second 2002	\$50	
First 2002	\$49	
Fourth 2001		\$1,238

The Board of Directors intends to continue its policy of declaring quarterly cash dividends. However, the fourth quarter's dividend will be based on client patronage, rather than equity ownership. The amount of dividends, as always, will depend on continued strong earnings, the overall financial condition of the Association and other factors.

The Association's regulatory permanent capital ratio at March 31, 2003 was 26.14 percent compared to 27.10 percent at December 31, 2002. The Association's total surplus and core surplus ratios were both 25.52 percent at March 31, 2003. All three ratios were well above the minimum regulatory ratios of 7.00 percent for permanent capital and total surplus ratios and 3.50 percent for the core surplus ratio.

**Key financial condition ratios were as follows:**

	<b>3/31/03</b>	<b>12/31/02</b>
Stockholders' Equity to Assets	21.81%	21.96%
Debt to Stockholders' Equity	3.59:1	3.55:1

*Puerto Rico Farm Credit, ACA*  
**Consolidated Balance Sheets**

<i>(dollars in thousands)</i>	<b>March 31,</b>		<b>December 31,</b>
	<b>2003</b>	<b>2002</b>	<b>2002</b>
	<i>(unaudited)</i>		
<b>Assets</b>			
Cash	\$ 10	\$ 20	\$ 92
Loans	207,706	178,343	204,510
Less: allowance for loan losses	6,498	6,500	6,498
Net loans	201,208	171,843	198,012
Accrued interest receivable	981	918	816
Investment in AgFirst Farm Credit Bank	4,712	4,712	4,712
Premises and equipment, net	575	777	474
Other assets	121	979	217
Total assets	<u>\$ 207,607</u>	<u>\$ 179,249</u>	<u>\$ 204,323</u>
<b>Liabilities</b>			
Notes payable to AgFirst Farm Credit Bank	\$ 159,030	\$ 132,160	\$ 154,689
Accrued interest payable	213	189	153
Dividend payable	51	50	1,602
Other liabilities	3,035	1,393	3,002
Total liabilities	<u>162,329</u>	<u>133,792</u>	<u>159,446</u>
Commitments and contingencies			
<b>Stockholders' Equity</b>			
Capital stock and participation certificates	1,013	987	1,001
Unallocated retained earnings	46,303	44,470	45,914
Accumulated other comprehensive income (loss)	(2,038)	—	(2,038)
Total stockholders' equity	<u>45,278</u>	<u>45,457</u>	<u>44,877</u>
Total liabilities and stockholders' equity	<u>\$ 207,607</u>	<u>\$ 179,249</u>	<u>\$ 204,323</u>

*The accompanying notes are an integral part of these financial statements.*

*Puerto Rico Farm Credit, ACA*  
**Consolidated Statements of Income**

*(unaudited)*

<i>(dollars in thousands)</i>	<b>For the three months ended March 31,</b>	
	<b>2003</b>	<b>2002</b>
<b>Interest Income</b>		
Loans	\$ 2,021	\$ 2,068
<b>Interest Expense</b>		
Notes payable to AgFirst Farm Credit Bank	628	538
Net interest income	1,393	1,530
Provision for (reversal of) loan losses	—	(174)
Net interest income after provision for (reversal of) loan losses	1,393	1,704
<b>Noninterest Income</b>		
Loan fees	67	41
Fees for financially related services	4	3
Miscellaneous	18	22
Total noninterest income	89	66
<b>Noninterest Expense</b>		
Salaries and employee benefits	697	639
Occupancy and equipment	53	53
Insurance Fund premium	60	15
Guarantee fee	57	45
Other operating expenses	174	185
Total noninterest expense	1,041	937
Income before income taxes	441	833
Provision (benefit) for income taxes	1	21
Net income	\$ 440	\$ 812

The accompanying notes are an integral part of these financial statements.

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*Puerto Rico Farm Credit, ACA*  
**Consolidated Statements of Changes in  
 Stockholders' Equity**

*(unaudited)*

<i>(dollars in thousands)</i>	<b>Capital Stock and Participation Certificates</b>	<b>Retained Earnings Unallocated</b>	<b>Accumulated Other Comprehensive Income</b>	<b>Total Stockholders' Equity</b>
Balance at December 31, 2001	\$ 974	\$ 43,712	\$ —	\$ 44,686
Net income		812		812
Capital stock/participation certificates issued	32			32
Capital stock/participation certificates retired	(19)			(19)
Cash dividends declared		(49)		(49)
Dividend adjustment		(5)		(5)
Balance at March 31, 2002	<u>\$ 987</u>	<u>\$ 44,470</u>	<u>\$ —</u>	<u>\$ 45,457</u>
Balance at December 31, 2002	\$ 1,001	\$ 45,914	\$ (2,038)	\$ 44,877
Net income		440		440
Capital stock/participation certificates issued	29			29
Capital stock/participation certificates retired	(17)			(17)
Cash dividends declared		(51)		(51)
Balance at March 31, 2003	<u>\$ 1,013</u>	<u>\$ 46,303</u>	<u>\$ (2,038)</u>	<u>\$ 45,278</u>

*The accompanying notes are an integral part of these financial statements.*

# Notes to the Consolidated Financial Statements

(dollars in thousands, except as noted)  
(unaudited)

## NOTE 1 – ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

A description of the organization and operations of Puerto Rico Farm Credit, ACA (the Association), the significant accounting policies followed, and the financial condition and results of operations as of and for the year ended December 31, 2002, are contained in the 2002 Annual Report to Stockholders. These unaudited first quarter 2003 consolidated financial statements should be read in conjunction with the 2002 Annual Report to Stockholders.

The accompanying consolidated financial statements contain all adjustments necessary for a fair presentation of the interim financial condition and results of operations and conform with generally accepted accounting principles. The results for the three months ended March 31, 2003, are not necessarily indicative of the results to be expected for the year ending December 31, 2003.

Certain amounts in prior period consolidated financial statements have been reclassified to conform to current consolidated financial statement presentation. Such reclassifications had no effect on the prior period net income or total capital as previously reported.

The Association maintains an allowance for loan losses in accordance with generally accepted accounting principles. The loan portfolio is reviewed quarterly to determine the adequacy of the allowance for losses. As of March 31, 2003, the allowance for losses is adequate in management's opinion to provide for possible losses on existing loans.

## NOTE 2 – ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses follows:

Balance at 12-31-01	\$ 6,674
(Reversal of) provision for loan losses	(174)
Recoveries, net of loans charged off	<u>—</u>
Balance at 3-31-02	<u>\$ 6,500</u>
Balance at 12-31-02	\$ 6,498
(Reversal of) provision for loan losses	—
Recoveries, net of loans charged off	<u>—</u>
Balance at 3-31-03	<u>\$ 6,498</u>

## NOTE 3 – COMMITMENTS AND CONTINGENT LIABILITIES

Actions are pending against the Association in which claims for money damages are asserted. Upon the basis of current information, management and legal counsel are of the opinion that the ultimate liability, if any, resulting there from, would not be material in relation to the financial position of the Association.